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## Research Update

*Investors should consider this report as only a single factor in making their investment decision.*

**Zynex, Inc.**

**Rating: Neutral**

Juan Noble

August 19, 2013

**ZYXI \$0.33 (ZYXI: OTC)**

	2011A	2012A	2013E	2014E
Total revenues (in millions)	\$34.1	\$40.0	\$22.9	\$14.0
Earnings (loss) per share	\$0.05	\$0.05	(\$0.14)	(\$0.11)

52 - Week range	\$1.01 – \$ 0.40	Fiscal year ends:	December
Shares outstanding as of Aug. 13, 2013	31.1 million	Revenue/share (ttm)	\$1.09
Approximate float	12 million	Price/Sales (ttm)	0.3X
Market Capitalization	\$10.3 million	Price/Sales (2014)E	0.4X
Tangible Book value as of Mar. 31, 2013	\$0.36	Price/Earnings (ttm)	0.8X
Price/Book	1.0 X	Price/Earnings (2014)E	NA

*Zynex, Inc., based in Lone Tree, Colorado, manufactures a line of electrotherapy devices that relieve pain while reducing reliance on drugs, and speeds rehabilitation and recovery of i mobility. The company also produces diagnostic devices and distributes electrotherapy systems manufactured by others. A substantial portion of revenue is recurring – device rentals and the sale of electrodes and batteries sent to patients using rented or purchased units.*

### **Key Investment Considerations:**

#### ***Reiterating Neutral investment rating.***

*Revenue gains have slowed, reflecting a drop in demand stemming from broad reductions in Medicare reimbursements for medical devices, Medicare's curtailment of reimbursement for TENS use to alleviate chronic lower back pain, and physician uncertainty over the impact of the Patient Protection and Affordable Care Act (PPACA).*

*ZYXI aims to drive its growth with newer products that are less affected by reduced reimbursement but restoring growth and profitability changes through changes in the sales mix could be a lengthy process.*

*Due to slowing demand and we have further reduced our revenue and earnings estimates for 2013 and 2014.*

*For 2013 we project a loss of (\$0.14) per share on revenue of \$22.9 million, down from our earlier projections of \$0.02 EPS on revenue of \$32 million. For 2014 we project a loss of (\$0.11) per share on revenue of \$14 million, down from \$0.04 EPS and revenue of \$35.3 million projected earlier.*

*In 2Q13 (results released Aug. 8, 2013) Zynex lost \$1.7 million, or (\$0.06) per share, on revenue of \$5.5 million. We projected 2Q EPS of \$0.01 on revenue of \$7.5 million. In the year-earlier quarter, the company earned \$0.02 per share on revenue of \$10 million.*

***See disclosures on pages 15 - 17***

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## Investment Recommendation

### Reiterating Neutral investment rating.

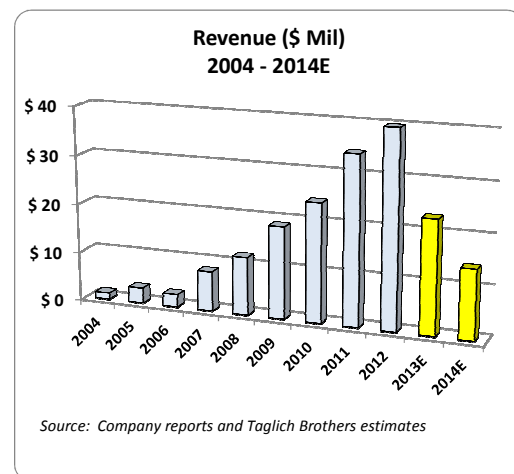
ZYXI is trading 0.3X trailing revenue vs. 7X for medical device stocks with market valuations of less than \$250 million. The deep discount from the sector multiple arguably stems from ZYXI's stalled revenue growth, worrisome year-ahead prospects, the stock's small float and light trading volume.

## Overview

Zynex, Inc., headquartered in Lone Tree, Colorado, was founded in 1996 and became a publicly held company in 2004 through a reverse merger with a shell company. Zynex operated as a wholesaler of European-made electrotherapy devices until its first medical device was cleared by the Food and Drug Administration (FDA) in 1999. In 2003 Zynex's full line of electrotherapy devices and a stroke rehabilitation device were cleared by the FDA. In 2008 some of its major products were cleared for marketing in Europe.

Zynex manufactures a line of pain management neuromodulator devices that reduce reliance on drugs and promotes rehabilitation and increased mobility. Zynex's non-invasive transcutaneous electrical nerve stimulation (TENS) and interferential current (IF) systems have been used to treat pain ranging from mild persistent problems such as sore muscles to acute postoperative pain.

The company's neuromuscular electrical stimulation (NMES) systems are used mainly by physical therapists to treat victims of trauma, stroke, or incidents that degrade muscle function, enabling stroke or spinal injury victims to regain lost mobility, functionality, speech, and memory. Revenue increased sharply, growing threefold in the three years through 2012. Profitability, however, has been less consistent despite a gross margin that significantly exceeds the medical device industry's gross margin of 50%. Although Zynex has been profitable since 2007, net income has fluctuated widely due mainly to sharp swings in operating expenses.



Revenue growth has stalled abruptly on an outlook that has become murky due to Medicare reimbursement cutbacks for medical devices (durable medical equipment), curtailment of Medicare reimbursement for TENS in treating chronic lower back pain, and uncertainty over the impact of the Patient Protection and Affordable Care Act (PPACA). In 2Q13, hardware sales and rental revenue fell sharply. The company aims to regain growth momentum through the sale of diagnostic devices unaffected by significant reimbursement cuts. But in light of Zynex's current sales mix, the recovery process could be a lengthy one.

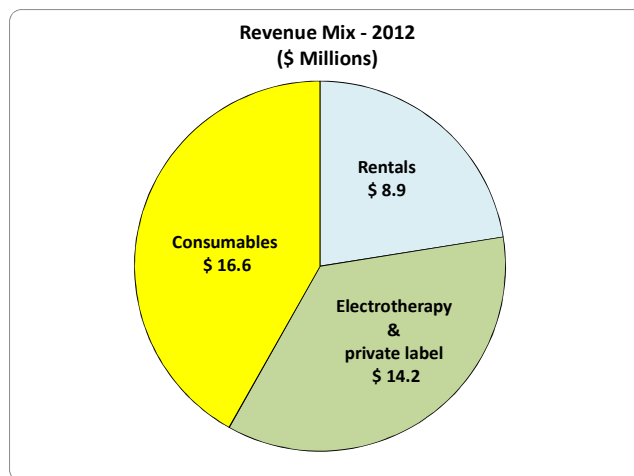
In March 2012 Zynex expanded its product line with the acquisition a diagnostics business that manufactures electromyography (EMG) and photoelectric plethysmography (PPG) systems. In March 2013 Zynex began distributing a line of electroencephalography (EEG) and sleep diagnostic devices manufactured by Neurovirtual (Doral, FL). Zynex has exclusive US rights to distribute Neurovirtual's EEG and sleep diagnostic devices.

In addition to its own products, Zynex distributes private labeled electrical stimulation devices, electrodes and batteries produced by other US manufacturers. A substantial portion of revenue is recurring. Rentals and electrodes and batteries sold to patients using either rental or purchased units account for two-thirds of revenue.

Zynex's products are either purchased or rented on a monthly basis, mainly by patients, health care providers and distributors. Health insurers that cover patients generally determine, based on the anticipated time the device will be used, if devices will be rented or purchased. More than half of revenue consists of sales to patients covered by

private health insurance plans. Patients also include Medicare and Medicaid beneficiaries. Returned rental units are refurbished and made available for future rentals. Rental margins and margins on consumables, typically around 80%, range significantly higher than the 50% margins on device sales.

At present, practically all of the company's revenue derives from electrotherapy systems but products that could potentially expand and diversify the company's target patient populations are in development. Zynex is developing electromyography (EMG), electroencephalography (EEG), sleep pattern, auditory and nerve conductivity neurological diagnosis devices for use in hospitals and clinics. Cardiac monitoring systems are also in development.



In the US, which accounts for most of its sales, the company sells its medical devices through a sales force that includes independent sales representatives. Overseas, Zynex has distributors in Canada, Australia, Southeast Asia, the United Arab Emirates, the Netherlands, and Germany. An international sales manager oversees distributors covering Asia and the Middle East.

### **Strategy**

The company plans to expand into new markets by developing new neurodiagnostic and cardiac monitoring products, and by making accretive acquisitions. At this time, however, most of the company's revenue derives from the rental and sale of pain management devices and consumables.

Zynex is reevaluating the strategy for Zynex Medical, its largest business. Previously growth plans aimed to increase market penetration by sales force expansion, mainly through the recruitment of in-house sales representatives. In the aftermath of a disappointing 1H13, the company has to diversify away from its electrotherapy products, which are based largely on aging technology and tend to be priced as commodities.

To attenuate the impact of a sharp decline in revenue, Zynex is reducing its staff, potentially cutting annual costs by \$3 million. The company has also renegotiated its lease, freeing itself from rent expenses for 12 months.

To respond more effectively to fluctuating volume, minimize capital expenditures, and spread the risk of quality deficiencies and supply interruptions, Zynex maximizes its use of contract manufacturers, of which there are a large number of qualified ones available in the US and overseas. Despite reliance mainly on contractors to process the bulk of the company's manufacturing requirements, Zynex has expanded its in-house production capability for certain TENS units.

Most of the company's technology – TENS was developed 30 years ago – is not patent protected. To keep its product knowledge proprietary, Zynex internally develops software for all of its products. All products are tested in-house to ensure quality and patient safety, and reduce the cost of warranty expenses.

### **Outlook**

With the aging of the population, the prevalence of age-related disease – cancer, cardiovascular disorders, stroke, diabetes, and degenerative spinal disorders – is expected to rise significantly, increasing the demand for pharmaceutical- and device-based therapy. Technological advances in device design, as seen earlier in cardiac

rhythm management, coronary revascularization devices, spinal implants, orthopedic prostheses, and neuromodulation systems, should also drive the growth in demand.

Gains could potentially be offset in part by more stringent regulatory 510(k) review mandated by the Food and Drug Administration Reform Act of 2012, and pressure on pricing and industry profits as the PPACA goes into effect. The law will require all medical device manufacturers to pay, starting in 2013, 2.3% of the sales price of a device as an industry fee.

The more immediate threat to Zynex's growth outlook stems from the curtailment of Medicare reimbursement. In March 2012 the Centers for Medicare and Medicaid (CMS) released a proposal that would eliminate existing coverage of TENS devices for chronic lower back pain after 90 days. A June 2013 decision memorandum from CMS determined that "TENS is not reasonable and necessary for the treatment of CLBP under section 1862(a)(1)(A) of the Social Security Act." That decision directly affects TENS device manufacturers. High-end neuromodulation device manufacturers such as Medtronic and St. Jude Medical (see Competition) have not experienced as severe an impact as Zynex has. But the EMPI business of DJO Global, a large TENS manufacturer, has suffered more significant revenue declines than either Medtronic or St. Jude Medical.

Last April, Medicare payments for services to physicians were reduced by 2% as part of the automatic spending cuts in Federal spending mandated by the Budget Control Act of 2011. In June 2013 CMS announced its proposal to reduce reimbursements for home healthcare by 3.5% annually from 2014 to 2017, exacerbating the impact of a Medicare competitive bidding program that critics allege will enable CMS to arbitrarily limit pricing for home healthcare equipment and services.

*Neuromodulation Devices* This \$6.5 billion segment of the US medical device market encompasses a wide range of devices that intervene in neural pathways to reduce pain and disorders stemming from illness and trauma that have impaired the central nervous system in some fashion. The neuromodulation segment includes electrotherapeutic devices, which apply an electrical impulse to an affected part of the anatomy. TENS systems fall within this group (which also includes cardiac rhythm management devices and other devices).

The US TENS market grew an average of 5.4% a year between 2000 and 2012. By IBISWorld's estimates, the US market for TENS in 2012 was \$646 million, a figure that could increase due to the higher prevalence of age-related disease and chronic pain stemming from the growth in the elderly segment of the population. However, broad reductions in Medicare coverage for durable medical equipment (which include medical devices) and new limitations on Medicare reimbursement for chronic lower back pain are likely to curtail usage of TENS devices, particularly in the home health market.

## ***Competition***

Zynex's competitors include large broad-line medical device manufacturers with substantial neurostimulation businesses, including Medtronic, which reported FY2012 (FY ending April 2013) neuromodulation revenue of \$1.8 billion, up 7%, a growth rate maintained throughout the period. St. Jude Medical reported 1H13 neuromodulation revenue of \$207 million, down 1% from the year-earlier period. St. Jude Medical attributed the decline to reduced sales of chronic pain management products.

DJO Global's Recovery Science business, reported 1H13 revenue of \$152.8 million, down 9% from the year-earlier period. DJO's Recovery Science's 2Q13 revenue of \$77.2 million dropped 8% from the 2Q12, a decline that was attributed in part to changes in reimbursement for certain products in DJO's EMPI business. EMPI's product line consists in large part of TENS devices.

Aside from the larger competitors in this industry segment, there are more than 40 US manufacturers of electrotherapy devices, most of which carry a wide variety of products sold to the physical therapy market.

Zynex, Inc.

IBISWorld's TENS market data imply an average annual revenue of around \$15 million per TENS manufacturer, making Zynex among the largest in this niche.

Competition is based on price, which is important to patients, clinicians and insurers. As all TENS devices perform the same function, based on largely dated technology, and are produced by a large number of manufacturers, they increasingly trade as commodities. Differentiating technology can also be an advantage. Despite limited potential for innovation in TENS devices, manufacturers try to differentiate their products. TENS systems are commonly differentiated by being bundled with another pain management modality, just as Zynex combines TENS with NMS and IF. Product innovations may make systems easier for untrained patients to use at home, or be mainly cosmetic, but in a commoditized market, novel features can underlie a slight competitive edge even if they do not enhance functionality.

**2013 Second Quarter and Six-Month Results**

In 2Q13, Zynex incurred a loss of \$1.7 million, or (\$0.06) per share, on revenue of \$5.5 million. We projected EPS of \$0.01 per share on revenue of \$7.5 million. In the year-earlier quarter, the company earned \$0.02 per share on revenue of \$10 million.

2Q revenue dropped 45% to \$5.5 million, a decline led by a 50% decrease in hardware sales to \$1.3 million. Rentals, the company's highest margin revenue, fell 33% to \$1.6 million. Consumables sales, driven mainly by the number of electrotherapy systems in service, dropped 35% to \$2.6 million. Gross profit for 2Q fell 56% to \$3.6 million, reflecting the decline in revenue and gross margin compression to 65.6% from 82.2%.

Operating expenses dropped 16% to \$6.2 million, led by a 40% decrease in sales/marketing expenses stemming from reduced sales commissions, and cuts in direct sales force employees and compensation. G&A expenses increased 34% to \$1.5 million due to an increase in administrative costs, mainly the hiring of more regulatory and administrative staff to support the ZND division (monitoring solutions).

(\$ Thousands)	Quarter ending Jun 30: '13 vs. '12				Six mos. ending Jun 30:		
	2013A	2013E	2012A	%+/-	2013	2012	%+/-
Revenue							
Rental	1,643	1,828	2,437	(33%)	3,322	4,499	(26%)
Sales: electrotherapy/private label consumables	1,255	2,717	3,622	(65%)	3,346	6,680	(50%)
Sales revenue	2,574	2,954	3,967	(35%)	6,472	7,791	(17%)
	<u>3,829</u>	<u>5,670</u>	<u>7,589</u>	<u>(50%)</u>	<u>9,818</u>	<u>14,471</u>	<u>(32%)</u>
Total revenue	5,472	7,498	10,026	(45%)	13,140	18,970	(31%)
Cost of revenue							
Rental	398	238	273	46%	699	531	32%
Sales	1,485	1,361	1,513	(2%)	3,375	3,068	10%
Total	<u>1,883</u>	<u>1,598</u>	<u>1,786</u>	<u>5%</u>	<u>4,074</u>	<u>3,599</u>	<u>13%</u>
Gross profit	3,589	5,900	8,240	(56%)	9,066	15,371	(41%)
Operating expenses							
Sales/marketing	2,274	1,875	3,805	(40%)	4,181	6,903	(39%)
Reimbursement & billing	2,037	2,062	2,047	(0%)	4,268	4,144	3%
G&A	1,508	1,200	1,127	34%	2,864	2,244	28%
Engineering & operations	334	225	329	2%	673	662	2%
Total SG&A	<u>6,153</u>	<u>5,361</u>	<u>7,308</u>	<u>(16%)</u>	<u>11,986</u>	<u>13,953</u>	<u>(14%)</u>
Operating income	(2,564)	538	932	(375%)	(2,920)	1,418	(306%)
Interest income							NM
Interest expense	(214)	(112)	(81)	164%	(344)	(174)	98%
Other income (expense)	78		(7)	NM	72	(7)	NM
Pretax income	(2,700)	427	844	(420%)	(3,192)	1,237	(358%)
Income tax	973	(171)	(371)	(362%)	1,155	(444)	(360%)
Income before minority interest	<u>(1,727)</u>	<u>256</u>	<u>473</u>		<u>(2,037)</u>	<u>793</u>	
Minority interest in earnings	11			NM	17		
Net income	<u>(1,716)</u>	<u>256</u>	<u>473</u>	<u>(463%)</u>	<u>(2,020)</u>	<u>793</u>	<u>(355%)</u>
Average shares outstanding	31,148	32,250	31,249		31,148	31,143	
Earnings (loss) per share	(0.06)	0.01	0.02	(464%)	(0.06)	0.03	(355%)
Margin Analysis							
Gross margin - total	65.6%	78.7%	82.2%		69.0%	81.0%	
Rental	75.8%	87.0%	88.8%		79.0%	88.2%	
Sales	61.2%	76.0%	80.1%		65.6%	78.8%	
SG&A	112.4%	71.5%	72.9%		91.2%	73.6%	
Sales/marketing	41.6%	25.0%	38.0%		31.8%	36.4%	
Reimbursement & billing	37.2%	27.5%	20.4%		32.5%	21.8%	
G&A	27.6%	16.0%	11.2%		21.8%	11.8%	
Engineering & operations	6.1%	3.0%	3.3%		5.1%	3.5%	
Operating income		7.2%	9.3%			7.5%	
Net income		3.4%	4.7%			4.2%	
Tax rate	(36.0%)	(40.0%)	(44.0%)		(36.2%)	(35.9%)	

Source: Company reports and Taglich Brothers estimates

## Zynex, Inc.

The decline in gross profit and the rise in operating expenses widened the company's 2Q13 operating loss to \$2.6 million from \$932,000

Interest expense increased almost threefold to \$214,000 due to increased borrowing, contributing to a pretax loss of \$2.7 million vs. a pretax profit of \$844,000 in 2Q12.

In the first half of 2013 Zynex lost \$2 million, or (\$0.06) per share, on revenue of \$13.1 million. In the year-earlier period, the company earned \$0.03 per share on revenue of \$19 million. Revenue for 1H13 fell 31% to \$13.1 million, led, in dollar terms, by a 50% drop in device sales. Gross profit declined 41% to \$9.1 million, reflecting the decrease in revenue and a narrowing in the gross margin to 69% from 81%.

Operating expenses declined 14% to \$12 million due mainly to a 39% drop in sales/marketing expenses, partly offset by a 28% rise in G&A. The 1H13 changes in sales/marketing and G&A expenses were driven by the same factors that influenced 1Q13 operating expenses. Due to the decline in gross profit and the rise in operating expenses, the company suffered a \$12 million operating loss. In 1H12, Zynex earned an operating profit of \$1.4 million.

Interest expenses doubled to \$344,000 due to increased borrowing. The company incurred a pretax loss of \$3.2 million, down from pretax income of \$1.2 million in 1H12.

Finances In 2Q13 Zynex burned cash of \$305,000 but reduced working capital increased by \$358,000 due mainly to reductions in receivables and inventory, and an increase in payables, offset partly by an increase in deposits and reductions in accruals and taxes payable. Capital expenditures of \$438,000 were offset in part by additional bank borrowings but cash dropped by \$236,000 to \$445,000 at the end of the quarter.

In the first half of 2013 the company burned \$274,000 and increased working capital by \$666,000 due to an increase in deposits and reductions in taxes payable and accruals, partly offset by a reduction in receivables. Cash of \$940,000 used in operations and capital expenditures were partly covered by additional bank borrowing but cash dropped by \$378,000 to \$445,000 as of June 30, 2013.

Credit Facility Under a December 2011 loan agreement with Doral Healthcare Finance, Zynex has an asset-backed revolving credit facility of up to \$7 million at a variable interest rate equal to the LIBOR rate or 3% per annum + 3.75%, whichever is greater. The agreement matures on December 19, 2014.

The company may terminate the agreement at any time prior to the maturity date upon 30 days' notice and upon full payment of all outstanding obligations. If Zynex terminates the agreement after December 19, 2012 but before the maturity date, the company must pay a specified early termination fee. As of June 30, 2013, \$6.9 million was outstanding under the agreement and \$16,000 was available for borrowing.

As of June 30, 2013, the effective interest rate under the agreement was 8% (7% interest rate and 1% fees). The agreement contains restrictive and financial covenants for asset-backed credit facilities. As of June 30, 2013, the company was in compliance with all loan covenants.

## **Projections**

Operations For 2013, we project a loss of \$4.6 million, or (\$0.14) per share, on revenue of 22.9 million. Previously we projected EPS of \$0.02 on revenue of \$32 million. We reduced our 2013 forecast to reflect 2Q results and expectations for reduced demand and orders due to the adverse factors threatening the company's revenue outlook. In our view, demand and profitability in 2014 will also be adversely affected by the same factors.

For 2013 we project a 42% decline in revenue and gross margin compression to 66.6% from 2012's 77.9%. Gross profit will fall an estimated 41% to \$9 million. Operating expenses should decrease by 22%, reflecting a 40%

decline in sales/marketing and the effect of staff reductions aimed at decreasing annual operating expenses by \$3 million. But with expenses falling at a slower rate than gross profit, Zynex will incur an operating loss of \$6.8 million, down from a 2012 operating profit of \$2.7 million. Interest expense will rise an estimated 44% to \$625,000 due to heavier borrowing.

We project a 2014 loss of \$3.8 million, or (\$0.11) per share, on revenue of \$14.1 million. We previously projected 2014 EPS of \$0.04 on revenue of \$35.3 million. We forecast a 39% drop in revenue to \$14 million and a 41% drop in gross profit stemming in part from gross margin compression to 64% from 66.6%. Operating expenses should drop more sharply, falling 33% to \$14.8 million the operating loss for the year should narrow to \$5.8 million from \$6.8 million. So long as collections do not deteriorate, average borrowings should drop, enabling Zynex to cut its interest expense 22% to \$490,000. Narrower operating losses and a reduction in interest expense should reduce pretax losses by 15% to \$6.3 million.

**Finances** We project cash burn for 2013 and 2014 of \$2.5 million and \$3.1 million, respectively. Reductions in working capital stemming from decreases in receivables, inventory, offset by decreases in accruals and payables should partially offset cash burn. Cash of \$1.4 million used in 2013 operations should be offset by additional borrowing that would increase cash by \$95,000 to \$918,000 at year end. Cash from 2014 operations of \$705,000 will fall short of capital expenditures, and (net) repayment of borrowings, reducing cash by \$205,000 to \$713,000 at the end of 2014.

**Zynex’s Electrical Nerve Stimulation Technology and its Product Line**

Zynex’s principal products include pain management, rehabilitation and diagnostic technologies, some of them bundled in combination systems. In addition to the electrical nerve stimulation and diagnostic systems (table on page 9) that it manufactures, the company manufactures private label systems such as an electrical stimulator that manages female urinary incontinence and an electronic drug delivery device. Single-use supplies such as electrodes and batteries account for a sizable proportion of revenue.

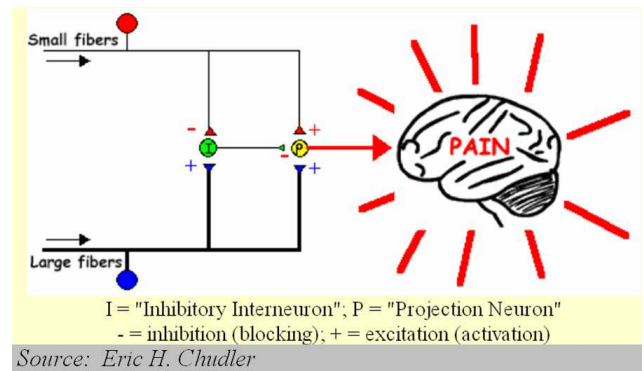


Electrotherapy devices are generally small, portable (hand-held in many cases), and relatively inexpensive. The TENS unit illustrated at right (not a Zynex product) is fairly typical. There are TENS systems that retail on the Internet for as little as \$30.

**Pain Management** Electrical stimulation systems, also known as neurostimulation devices, range from Medtronic’s PrimeAdvanced® and Restore™ implantables to the ubiquitous TENS (transcutaneous electrical nerve stimulation) system. TENS reduces pain by electrically stimulating nerve fibers that interfere with pain signals and by stimulating the production of pain-relieving endomorphins. Common pain relief applications for TENS include back and neck, RSD (complex regional pain syndrome), arthritis, shoulder pain, neuropathies, and other acute and chronic pain.

TENS therapy is delivered through a small, external portable battery-powered generator from which electrical impulses are coursed through electrodes placed on the skin, either directly over the painful area or at certain points along the nerve pathway.

The mechanism of action of TENS is explained by the gate-control theory (Melzack and Wall, 1965), illustrated at the right, as follows: in the absence of stimuli, both large and small nerve fibers are quiet and the inhibitory



interneuron (I) blocks the signal in the projection neuron (P) that connects to the brain. The "gate is closed", so there is no pain sensed.

With non-painful stimuli, mainly the large nerve fibers are activated. Activation of the large nerve fibers also activates the projection neuron (P), but it also activates the inhibitory interneuron (I) which then blocks the signal in the projection neuron (P) that connects to the brain. The gate remains closed so there is no pain sensed.

With pain stimulation, small nerve fibers become active, activating the projection neurons (P) and blocking the inhibitory interneuron (I). Because activity of the inhibitory interneuron is blocked, it cannot block the output of the projection neuron that connects with the brain. So the gate is "open", and the brain senses pain. TENS aims to stimulate the large diameter nerve fibers, closing the gate and reducing pain.

The sensation produced by the electrical stimulation appears to "override" the pain messages and may stimulate the body to produce its own natural morphine-like substance, which minimizes pain.

Since it was developed more than 30 years ago TENS has been used to treat almost every type of pain, from mild persistent problems such as sore muscles to acute postoperative pain. Its most common use, however, has been in the treatment of chronic low-back pain, an application in which the American Academy of Neurology now says TENS is ineffective. Whether TENS suppresses or overrides pain signals, stimulates production of natural pain relieving chemicals, or is merely a placebo effect, it has provided pain relief in many cases. Its broad acceptance is based in part on its benign side effects profile. TENS is non-addictive, non-sedative, and can be used indefinitely without the problems associated with prolonged use of some pain medications.

Zynex's pain management technologies include interferential (IF) current, which manages pain by a mechanism similar to TENS. Low-frequency electrical impulses directed at affected tissues intersect below the skin and induce the secretion of endorphins. IF penetrates tissue more deeply than TENS, achieving greater patient comfort and increased circulation. IF is often used to treat spasms, ligament sprains and strained muscles.

**Rehabilitation** Neuromuscular electrical stimulation (NMES) systems deliver electrical impulses to the surface over targeted muscles through electrodes. These electrical impulses cause muscles to contract as a form of exercise or physical therapy. NMES is used mainly by physical therapist to treat victims of trauma, stroke, or incidents that degrade muscle function. NEMS is also to diagnose the performance of nerves and muscles, and measure improvement after treatment.

NEMS is used in cases of chronic neuromuscular disorders such as cerebral palsy, spina bifida, club foot and some nonprogressive myopathies. It is also applied to healthy muscle to strengthen or maintain muscle mass during periods of enforced inactivity, increase range of motion, improve voluntary muscle control, and temporarily reduce spasticity.

**Diagnostics** Electromyography (EMG) tests the electrical activity of muscles to assess their health and the nerves that control them. EMG is often performed in tandem with nerve conduction studies. Detecting abnormal electrical activity in the muscles or nerves can help clinicians diagnose injuries or other disorders, such as nerve compression or injury (as in carpal tunnel syndrome), nerve root injury, and others, including alcoholic neuropathy, cervical spondylosis, and femoral nerve dysfunction. A very thin needle electrode inserted through the skin into the muscle detects electrical activity, which is displayed on a monitor, and may be heard through a speaker.

<b>PAIN MANAGEMENT/REHABILITATION</b>	
TENS	TruWave ValuTENS (private label)
MNES	E-Wave
Combination:	
IF and NMES	IF 8000 and IF 8100
TENS, NMES and IF	NexWave, TruWave Plus
TENS and NMES	InWave
<b>DIAGNOSTICS</b>	
Electromyography	NM 900 NeuroSys/3 System
Photoelectric plethysmograph	MEDAC Sys/3 System
<i>Source: Zynex, Inc.</i>	



Photoelectric plethysmography (PPG) measures the intensity of light reflected from the skin surface and the red cells below to determine the blood volume of the target. That measurement enables a physician to determine erythrocyte volume and oxygen saturation. The diagnostic procedure utilizes a photosensitive cell to measure light reflected or passed through the tissue segment where a monitor is positioned. In a common application, the PPG sensor is placed over a fingertip. With each heartbeat, a surge of blood is forced through the vascular system, expanding the capillaries in the finger, changing the amount of electrical current that is translated into a signal. PPG can be used to assess the condition of patients suffering from hypertension, migraine headache or Raynaud's Disease.

In another application, PPG measures and records ear opacity through a tiny phototube and lamp clipped to the ear, measuring of the fullness of blood vessels. A PPG can be worn by aircraft pilots during high-altitude flights to signal oxygen insufficiency.

## **Risks**

In our view, these are the principal risks underlying the stock:

Regulatory/Legal Zynex's devices must be cleared for US marketing by the FDA, mostly through the 510(k) review process, a relatively low regulatory hurdle that requires the company to demonstrate that a product under review is substantially equivalent to a similar device on the market (predicate device) before 1976. Devices sold in the European Union (EU) must be CE (Conformite Europeenne) marked, showing that it meets EU health, safety, and environmental requirements.

The Patient Protection and Affordable Care Act (PPACA) of 2010, which must be fully implemented by 2019, contains provisions that will increase pressure on pricing and require medical device manufacturers to pay fees on their sales. Adverse proposals by the Medicare system could cripple near-term growth.

Intervening Technnology Zynex's technology is protected by trademarks and trade secrets, rather than patents. While the company keeps it software proprietary by developing and maintaining it internally, competitors could potentially develop more effective devices.

Reimbursement Applications for reimbursement are subject to disputes which can result in carriers' requests for refunds of previously paid claims. Refunds are frequently offset after review of the billings in question, and the sums refunded have been largely immaterial. Potential for refunds underlies some revenue uncertainty. Potential for refunds underlies some revenue uncertainty.

Reimbursement requests filed electronically must meet the more detailed requirements of a new coding system and be submitted under a revised processing system. Difficulty in conforming to the new requirements could result in delays or failure to secure reimbursement for products sold to health insurance pan beneficiaries.

Concentration of Receivables One private health insurance carrier accounted for 10% of net accounts receivable as June 30, 2012. If this carrier proved to be especially problematical, reimbursements might be lost or delayed.

Competition The market for electrotherapy devices is fragmented and highly competitive. TENS and interferential current technologies have been on the market for more than 30 years and these devices increasingly tend to trade as commodities with limited pricing flexibility.

Concentration of stock ownership Thomas Sandgaard owns 57% of ZYXI shares. This concentration of ownership gives him disproportionate influence over management actions, potentially leading to decisions that may not be in the best interest of the stockholders at large.

Potential Dilution The sale of common shares to raise capital would dilute the ownership interests of current shareholders.

Microcap Concerns Shares of ZYXI have risks common to the stocks of other microcap (which we define as market capitalizations of \$250 million or less) companies. These risks often underlie stock price discounts from the valuations of larger-capitalization stocks. Liquidity risk, typically caused by small trading floats and very low trading volume, can lead to large spreads and high volatility in stock price. The company has approximately 12 million shares in the float. Average daily volume is 11,700 shares.

Miscellaneous Risks The company's financial results and equity values are subject to other risks and uncertainties known and unknown, including but not limited to competition, operations, financial markets, regulatory risk, and/or other events. These risks may cause actual results to differ from expected results.

Zynex, Inc.

Balance Sheets  
(\$ 000)  
2010A –2014E

	2010A	2011A	2012A	2Q13A	2013E	2014E
<b>ASSETS</b>						
Current assets						
Cash + equivalents	602	789	823	445	918	713
Accts receivable	7,309	10,984	12,224	9,775	7,331	4,488
Inventory	3,641	4,556	6,160	5,845	5,679	3,611
Prepaid expenses	145	293	243	194	122	74
Deferred tax asset	794	1,384	1,855	1,855	1,154	971
Other	41	42	57	1,255	1,000	1,000
<b>Total</b>	<b>12,532</b>	<b>18,048</b>	<b>21,362</b>	<b>19,369</b>	<b>16,203</b>	<b>10,858</b>
Fixed assets (net)						
Deposits	174	170	171	573	175	175
Deferred financing fees	89	145	98	73	150	150
Intangibles			203	73	49	1
Goodwill			251	212	251	251
<b>TOTAL ASSETS</b>	<b>15,701</b>	<b>21,785</b>	<b>25,936</b>	<b>24,149</b>	<b>20,006</b>	<b>14,482</b>
<b>LIABILITIES AND EQUITY</b>						
Current liabilities						
Line of credit	1,270	3,289	5,906	6,870	8,000	7,500
Notes & other obligations - curr	93	131	144	131	140	140
Accts pay	1,313	2,189	2,057	2,108	2,130	1,404
Accruals	1,552	2,276	1,430	1,256	1,190	794
Income taxes payable	1,103	1,567	2,164	891		
Deferred rent	221	296	371	364	325	325
Contingencies - curr			21	10	25	25
<b>Total</b>	<b>5,552</b>	<b>9,748</b>	<b>12,093</b>	<b>11,630</b>	<b>11,810</b>	<b>10,189</b>
Notes & other obligations (less curr)	327	258	114	135	200	200
Deferred rent	1,452	1,156	785	1,470	500	500
Deferred tax liability	188	483	786	786	500	500
Warranty liability			20	20	20	20
Contingencies - less curr			83	21	120	120
Shareholders' equity	8,182	10,140	12,055	10,087	6,856	2,951
<b>TOTAL LIABILITIES AND EQUITY</b>	<b>15,701</b>	<b>21,785</b>	<b>25,936</b>	<b>24,149</b>	<b>20,006</b>	<b>14,482</b>

Source: Company reports and Taglich Brothers estimates

Zynex, Inc.

Annual Income Statements  
(\$ 000)  
2010A –2014E

	2010A	2011A	2012A	2013E	2014E
Revenue					
Rental	8,533	9,892	8,917	5,531	3,760
Sales	15,552	24,256	30,749	17,418	10,289
Total	24,085	34,148	39,666	22,949	14,050
Cost of revenue					
Rental	802	1,842	1,283	1,251	940
Sales	4,400	5,529	7,487	6,415	4,116
Total	5,202	7,371	8,770	7,666	5,056
Gross profit	18,883	26,777	30,896	15,283	8,994
SG&A expenses					
Sales/marketing	6,331	9,340	13,340	8,104	5,620
Reimbursement & billing	6,261	7,969	8,944	7,701	4,917
G&A	3,246	4,278	4,702	5,316	3,846
Engineering & operations	1,484	2,089	1,173	968	421
Total SG&A	17,322	23,676	28,159	22,090	14,805
Operating income	1,561	3,101	2,737	(6,807)	(5,811)
Interest income	5	1	3		
Interest expense	(215)	(460)	(435)	(625)	(490)
Other income (expense)	(16)	2	31		
Pretax income (loss)	1,335	2,644	2,336	(7,432)	(6,300)
Income tax (benefit)	(985)	(1,080)	(788)	2,822	2,520
Net income	350	1,564	1,548	(4,610)	(3,780)
Average shares outstanding	30,705	30,978	31,222	31,887	33,375
Earnings (loss) per share	0.01	0.05	0.05	(0.14)	(0.11)
Margin Analysis					
Gross margin - total	78.4%	78.4%	77.9%	66.6%	64.0%
Rental	90.6%	81.4%	85.6%	77.4%	75.0%
Sales	71.7%	77.2%	75.7%	63.2%	60.0%
SG&A					
Sales/marketing	26.3%	27.4%	33.6%	35.3%	40.0%
Reimbursement & billing	26.0%	23.3%	22.5%	33.6%	35.0%
G&A	13.5%	12.5%	11.9%	23.2%	27.4%
Engineering & operations	6.2%	6.1%	3.0%	4.2%	3.0%
Total SG&A	71.9%	69.3%	71.0%	96.3%	105.4%
Operating income	6.5%	9.1%	6.9%		
Net income	1.5%	4.6%	3.9%		
Tax rate	(73.8%)	(40.8%)	(33.7%)	(38.0%)	(40.0%)

Source: Company reports and Taglich Brothers estimates

**Quarterly Income Statements**  
(\$ Thousands)  
**2012E - 2014E**

	1Q12A	2Q12A	3Q12A	4Q12A	2012A	1Q13A	2Q13A	3Q13E	4Q13E	2013E	1Q14E	2Q14E	3Q14E	4Q14E	2014E
Revenue															
Rental	2,062	2,437	2,281	2,137	8,917	1,679	1,643	1,141	1,069	5,531	1,007	986	912	855	3,760
Sales: electrotherapy/private label pdts	3,058	3,622	3,783	3,689	14,152	2,091	1,255	1,892	1,845	7,082	1,255	753	1,513	1,476	4,996
consumables	3,824	3,967	4,038	4,768	16,597	3,898	2,574	1,971	1,893	10,336	1,583	1,391	1,182	1,136	5,293
Total sales	6,882	7,589	7,821	8,457	30,749	5,989	3,829	3,862	3,738	17,418	2,838	2,144	2,696	2,612	10,289
Total revenue	8,944	10,026	10,102	10,594	39,666	7,668	5,472	5,003	4,806	22,949	3,845	3,130	3,608	3,466	14,050
Cost of revenue															
Rental	258	273	279	473	1,283	301	398	285	267	1,251	252	246	228	214	940
Sales	1,555	1,513	1,937	2,482	7,487	1,890	1,485	1,545	1,495	6,415	1,135	858	1,078	1,045	4,116
Total	1,813	1,786	2,216	2,955	8,770	2,191	1,883	1,830	1,762	7,666	1,387	1,104	1,306	1,258	5,056
Gross profit	7,131	8,240	7,886	7,639	30,896	5,477	3,589	3,173	3,044	15,283	2,458	2,026	2,302	2,208	8,994
SG&A expenses															
Sales/marketing	3,095	3,805	3,497	2,943	13,340	1,906	2,274	2,001	1,923	8,104	1,538	1,252	1,443	1,387	5,620
Reimbursement & billing	2,034	2,047	2,425	2,438	8,944	2,231	2,037	1,751	1,682	7,701	1,346	1,095	1,263	1,213	4,917
G&A	1,183	1,127	1,099	1,293	4,702	1,356	1,508	1,251	1,202	5,316	961	939	992	953	3,846
Engineering & operations	333	329	153	358	1,173	340	334	150	144	968	115	94	108	104	421
Total SG&A	6,645	7,308	7,174	7,032	28,159	5,833	6,153	5,153	4,951	22,090	3,961	3,380	3,807	3,657	14,805
Operating income	486	932	712	607	2,737	(356)	(2,564)	(1,980)	(1,906)	(6,807)	(1,502)	(1,354)	(1,505)	(1,449)	(5,811)
Interest income				3	3										
Interest expense	(93)	(81)	(119)	(142)	(435)	(130)	(214)	(136)	(145)	(625)	(125)	(117)	(121)	(125)	(490)
Other income (expense)		(7)	(6)	44	31	(6)	78								
Pretax income	393	844	587	512	2,336	(492)	(2,700)	(2,116)	(2,052)	(7,432)	(1,628)	(1,472)	(1,626)	(1,574)	(6,300)
Income tax (benefit)	(73)	(371)	(229)	(115)	(788)	182	973	846	821	2,822	651	589	651	630	2,520
Net income before minority interest						(310)	(1,727)								
Minority interest in earnings						6	11								
Net income	320	473	358	397	1,548	(304)	(1,716)	(1,270)	(1,231)	(4,610)	(977)	(883)	(976)	(945)	(3,780)
Average shares outstanding	31,037	31,249	31,317	31,285	31,222	31,148	31,148	32,500	32,750	31,887	33,000	33,250	33,500	33,750	33,375
Earnings (loss) per share	0.01	0.02	0.01	0.01	0.05	(0.01)	(0.06)	(0.04)	(0.04)	(0.14)	(0.03)	(0.03)	(0.03)	(0.03)	(0.11)

Source: Company reports and Taglich Brothers estimates

Zynex, Inc.

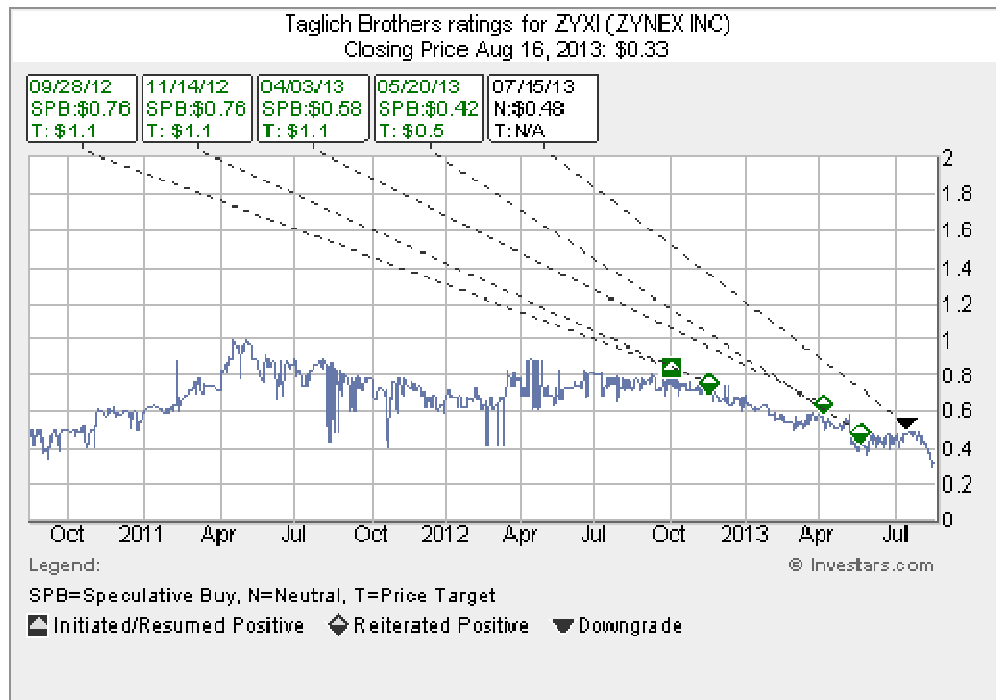
Annual Cash Flow Statements  
(\$ 000)  
2010A –2014E

	2010A	2011A	2012A	2Q13A	2013E	2014E
<b>Operating activities</b>						
Net Income	350	1,564	1,548	(1,727)	(4,538)	(3,780)
Depreciation/ amortization	774	806	864	204	610	401
Accretion of contingency consideration			(31)	(74)	(70)	
Provision for losses - accts rec	317	1,190	485	153	449	320
Amortization of intangibles			48	15	54	48
Impairment of goodwill				39	39	
Impairment of intangibles				100	100	
Amortization - financing fees	71	91	50	12	25	
Stock based compensation - employees	267	267	166	33	159	180
Stock based compensation for services	79	79	20			
Provision for obsolete inventory	23	149	573	175	192	
Deferred rent	1,129	(221)	(296)	771	528	(300)
Net loss - disposal of equipment	18					
Deferred tax benefit	(281)	(295)	(168)			
Gain on value of derivative liability				(6)	(6)	
Changes in working capital	(3,412)	(3,992)	(4,138)	358	1,081	3,837
Net cash from operations	(665)	(362)	(879)	53	(1,377)	705
<b>Investing activities</b>						
Proceeds on lease termination	108					
Cash paid for domain name			(18)			
Payment on contingency				(3)	(3)	
Capital expenditures				(438)	(438)	
Cash paid for acquisition			(245)			
Change in rental equip/inventory	(672)	(1,267)	(1,321)	(81)	(39)	(270)
Net - investing activities	(564)	(1,267)	(1,584)	(522)	(480)	(270)
<b>Financing activities</b>						
Net change - line of credit	1,270	2,019	2,617	268	2,094	(500)
Deferred financing fees	(120)	(147)	(2)			
Payments - capital lease obligations	(182)	(104)	(131)	(35)	(142)	(140)
Proceeds - issuance of stock		48	13			
Net cash from financing	968	1,816	2,497	233	1,952	(640)
Net change in cash	(261)	187	34	(236)	95	(205)
Cash - beginning	863	602	789	681	823	918
Cash - ending	602	789	823	445	918	713

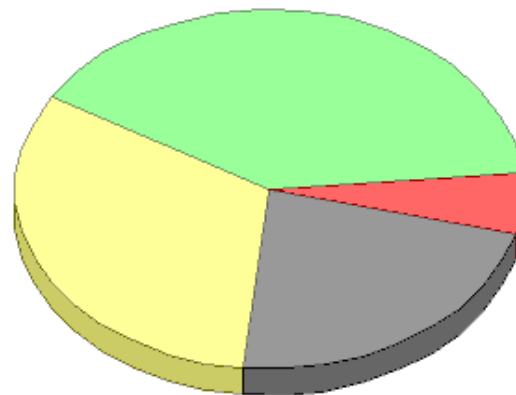
Source: Company reports and Taglich Brothers estimates

Zynex, Inc.

**Price Chart**



**Taglich Brothers Current Ratings Distribution**



■ 40 % Buy    ■ 32 % Hold    ■ 22.67 % Not Rated    ■ 5.33 % Sell

**Investment Banking Services for Companies Covered in the Past 12 Months**

Rating	#	%
Buy	1	4
Hold	1	14
Sell		
Not Rated		

Zynex, Inc.

### **Important Disclosures**

At this writing, none of Taglich Brothers' affiliates, officers, directors or stockholders, or any member of their families have a position in the stock of Zynex, Inc. Taglich Brothers, Inc. does not have an investment banking relationship with Zynex, Inc. and was not a manager or co-manager of any offering for the company within the last three years.

All research issued by Taglich Brothers, Inc. is based on public information. In September 2012 the company paid an initial monetary engagement fee of US\$4,500 to Taglich Brothers, Inc. representing payment for the first three months of creation and dissemination of research reports, after which the company will pay Taglich Brothers, Inc. a monetary fee of US\$1,500 per month for a minimum of three more months for such services.

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### **Analyst Certification**

**I, Juan Noble, the research analyst of this report, hereby certify that the views expressed in this report accurately reflect my personal views about the subject securities and issuers; and that no part of my compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in this report.**

### **Public companies mentioned in this report**

ITT Corporation	(NYSE: ITT)	Qualmark	(OTC: QMRK)
Koninklijke Philips Electronics NV	(NYSE: PHG)	Siemens AG	(NYSE: SI)
Medtronic	(NYSE: MDT)	St. Jude Medical	(NYSE: STJ)



### **Meaning of Ratings**

**Buy** – The growth prospects, degree of investment risk, and valuation make the stock attractive relative to the general market or comparable stocks.

**Speculative Buy** – Long term prospects of the company are promising but investment risk is significantly higher than it is in our BUY-rated stocks. Risk-reward considerations justify purchase mainly by high risk-tolerant accounts. In the short run, the stock may be subject to high volatility and could continue to trade at a discount to its market.

**Neutral** – Based on our outlook the stock is adequately valued. If investment risks are within acceptable parameters, this equity could remain a holding if already owned.

**Sell** – Based on our outlook the stock is significantly overvalued. A weak company or sector outlook and a high degree of investment risk make it likely that the stock will underperform relative to the general market.

**Dropping Coverage** – Research coverage discontinued due to the acquisition of the company, termination of research services, non-payment for such services, diminished investor interest, or departure of the analyst.

### **Some notable Risks within the Microcap Market**

**Stocks in the Microcap segment of the market have many risks that are not as prevalent in Large-cap, Blue Chips or even Small-cap stocks. Often it is these risks that cause Microcap stocks to trade at discounts to their peers. The most common of these risks is liquidity risk, which is typically caused by small trading floats and very low trading volume which can lead to large spreads and high volatility in stock price. In addition, Microcaps tend to have significant company specific risks that contribute to lower valuations. Investors need to be aware of the higher probability of financial default and higher degree of financial distress inherent in the microcap segment of the market.**

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From time to time our analysts may choose to withhold or suspend a rating on a company. We continue to publish informational reports on such companies; however, they have no ratings or price targets. In general, we will not rate any company that has too much business or financial uncertainty for our analysts to form an investment conclusion, or that is currently in the process of being acquired.